

PALAU PUBLIC UTILITIES CORPORATION
(A COMPONENT UNIT OF THE REPUBLIC OF PALAU)

FINANCIAL STATEMENTS,
ADDITIONAL INFORMATION
AND
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2013 AND 2012

INDEPENDENT AUDITORS' REPORT

Board of Directors
Palau Public Utilities Corporation:

Report on the Financial Statements

We have audited the accompanying financial statements of the Palau Public Utilities Corporation (PPUC), a component unit of the Republic of Palau, which comprise the statements of net position as of September 30, 2013 and 2012, and the related statements of revenues, expenses and changes in net position and of cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Palau Public Utilities Corporation as of September 30, 2013 and 2012, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 3 through 13 be presented to supplement the basic financial statements. Such information, although not part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Financial Information

Our audits were conducted for the purpose of forming an opinion on the financial statements as a whole. The combining statement of net position and combining statement of revenues, expenses and changes in net position on pages 29 and 30 are presented for purposes of additional analysis and are not a required part of the basic financial statements.

The combining statement of net position and combining statement of revenues, expenses and changes in net position are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the combining statements of net position and combining statements of revenues, expenses and changes in net position are fairly stated, in all material respects, in relation to the basic financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated June 30, 2014 on our consideration of PPUC's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering PPUC's internal control over financial reporting and compliance.



June 30, 2014

PALAU PUBLIC UTILITIES CORPORATION
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Management's Discussion and Analysis
Years Ended September 30, 2013 and 2012

This Management's Discussion and Analysis (MD&A) presents the Palau Public Utilities Corporation's financial performance during the fiscal year ended September 30, 2013. Please read it in conjunction with the audited financial statements as of and for the year ended September 30, 2013, which follow this section.

In preparing this MD&A, forward-looking remarks about operational and/or financial matters may be used. Such remarks are usually identified by words such as "expected", "could", etc. Matters discussed in these remarks are subject to risks and changes. The reader should not assume such remarks are guarantees.

MISSION AND OPERATIONS

Initially created as Public Utilities Corporation (PUC) on July 6, 1994, PUC was mandated by law to plan, develop and execute an electrification plan for the entire Republic. Almost three quarters into FY2013, PUC was merged with the one year old Palau Water & Sewer Corporation (PWSC) to create one comprehensive utility corporation designated as Palau Public Utilities Corporation (PPUC), wholly owned by the Republic of Palau (ROP).

Electric Power Operation:

To date, PPUC has succeeded in meeting its electrification mandate with the exception of the three southern-most islands of Tobi, Sonsorol and Pulo Anna. Due to distance and isolation, electrification of these islands has been slow in developing.

PPUC operates five (5) power systems throughout Palau. The two largest systems are located in Koror and Babeldaop, feeding the KB grid that services roughly 95% of Palau's population. The remaining three smaller power systems are located in Peleliu, Angaur and Kayangel servicing less than five hundred people combined. The power systems are primarily fossil fuel driven which makes PPUC vulnerable to spikes in the fuel market.

In step with the National Energy Policy (NEP), PPUC has established a Renewable Energy Division (created in 2010), tasked with research, exploration and development of PPUC's renewable energy sector. The division has already undertaken responsibility for the maintenance of the Ngerulmud Capitol Solar System as well as management and maintenance of PPUC's solar system installed at the Palau International Airport. In partnership with the Palau Energy Office, the division continues to pursue opportunities for expanding PPUC's Renewal Energy (RE) platforms, and has to date achieved 2% of its goal of achieving 20% RE by the year 2020. Management is in the process of negotiating a power purchase agreement with an independent power producer for purchase of energy generated by their proposed 5MW solar plant. Should this materialize, PPUC will have achieved roughly 13% of its RE goal.

In addition to energy alternatives, PPUC continues its efforts toward fuel efficiency and reduction of energy losses with upgrades to its aging infrastructure and equipment. To date, PPUC has achieved the following:

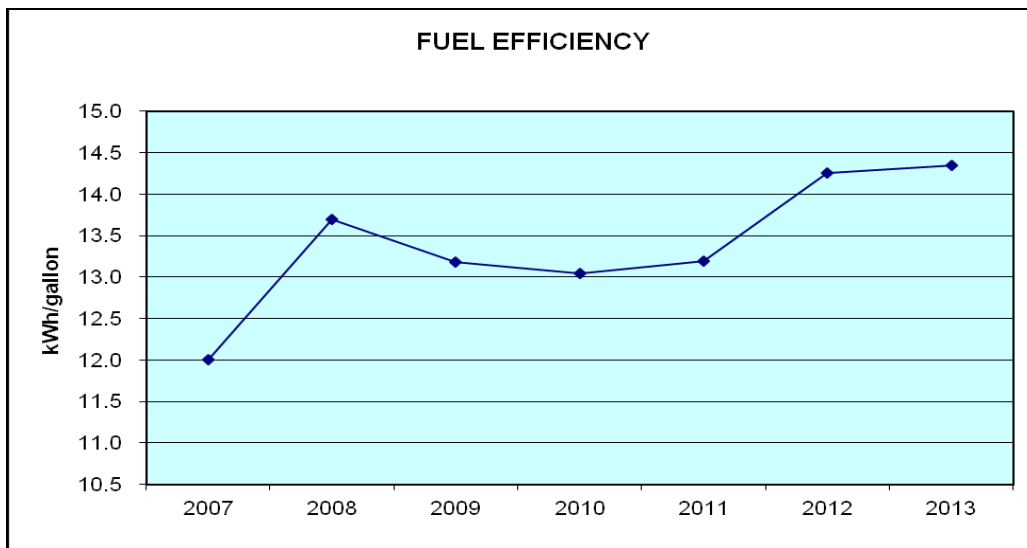
- Installed and commissioned two 5MW generators at the Malakal Power Plant on August 11, 2011. With the new larger units in operation, PPUC has realized fuel savings evidenced by the fuel economy graph below.
- Acquired four small 0.5MW generators for backup power through a grant aid for over \$2M during FY2012.

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- Commissioned shortly after FY2013 a new power plant facility equipped with two brand new 5MW baseload generators at its Aimeliik location. This project was funded by a grant from Japan to ROP, of which PPUC is the beneficiary.
- Recently contracted and concluded feasibility and assessment studies for the following projects, aimed at improving efficiencies and reducing losses:
 - A feasibility study for the upgrade and expansion of the Supervisory Control And Data Acquisition (SCADA) system which recommended improvements in two phases. Presently PPUC is preparing a Request For Proposal (RFP) for the implementation of Phase 1 Upgrade which will provide real time collection of grid performance data including control which will allow for efficient system monitoring and control, thereby reducing system losses.
 - A conditions assessment study for 3 storage tanks at Aimeliik Power Plant Tank Farm as part of environmental protection measures and enhancing fuel supply security for PPUC plants. An RFP is being initiated to rehabilitate and repair the tanks. Completion of the project will prevent catastrophic environmental degradation due to tank failures and ensure continuous supply of diesel fuel to the Aimeliik Power Plant.
 - A Transmission and Distribution lines Assessment/Investigation in priority areas of Koror and Babeldaob using Radio Frequency and Ultra Sonic Technology which has identified 12 areas of concerns that require pole hardware and devices replacement. An in-house program is being planned to address these findings, which will contribute to reduction of system losses due to arching as well as reduction of potential causes for power outages.

The chart below reflects PPUC's overall generation performance for the last seven years. As seen in the graph, management undertakings, which commenced in FY2010, yielded significant improvements to its generation plants up to current.



In addition to upgrades and expansion efforts, PPUC management is cognizant of the high cost of maintenance which impacts its customers and, therefore, is undertaking proactive efforts to control and

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minimize such costs. In 2013, PPUC management successfully negotiated an informal purchase arrangement directly with a manufacturer for supply of maintenance parts for the two 5MW units in Malakal resulting in material savings of about half a million dollars. Further, PUC terminated an Operations & Maintenance Contract with a contractor for their failure to provide sound technical advice and an inferior maintenance program. Streamlining purchases, thus, eliminating unnecessary middlemen and cost will be pursued on future orders. PPUC management will strive to ensure full return on monies spent.

On November 5, 2011, PPUC suffered an unfortunate fire to its Aimeliik Power Plant, effectively decommissioning all four Pielstick generators, a combined generation capacity of 8MW. This forced power rationing and brown-outs for a brief period of two months. In collaboration with the National Government, PPUC was able to purchase and install a brand new 2MW CAT generator at the plant to augment power supply, until repair works concluded on the main baseload units installed at Malakal. Loss suffered from the fire exceeded \$1.2M.

Water and Wastewater Operations:

PPUC, through the Merger Act, has undertaken management of a water and sewer system that dates back to 1987. Significant and material improvements are needed to upgrade the systems' capacity to accommodate the domestic and commercial growth since then, plus anticipated growth in the near future. Substantial efforts had preceded the merger that secured long-term soft-loans through the Asian Development Bank (ADB) to finance some improvements to the water system and capacity-expansion for the sewer systems of the two densely populated cities of Koror and Airai (roughly \$28M). PPUC continues to pursue potential funding sources to meet its mission respective of water and sewer needs, the accomplishment of which should enable PPUC to operate under a commercially viable framework.

FINANCIAL HIGHLIGHTS

The following summarizes PPUC's combined financial position and revenues, expenses, and changes in net position during the year.

Table 1

(Dollars in Thousands)

	Sept 30, 2013	Sept 30, 2012	Sept 30, 2011	Inc (Dec) 2013	Inc (Dec) 2012
Statements of Net Position					
Current assets	\$ 19,273	\$ 16,682	\$ 20,479	\$ 2,591	\$ (3,797)
Other assets	271	228	203	43	25
Net utility plant	41,149	26,620	26,262	14,529	358
Total assets	60,693	43,530	46,944	17,163	(3,414)
Current liabilities	7,480	7,502	10,018	(22)	(2,516)
Other liabilities	7,541	8,079	8,607	(538)	(528)
Total liabilities	15,021	15,581	18,625	(560)	(3,044)
Net investment in capital assets	35,879	20,996	17,346	14,883	3,650
Unrestricted	9,793	6,953	10,973	2,840	(4,020)
Total net position	\$ 45,672	\$ 27,949	\$ 28,319	\$ 17,723	\$ (370)

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Table 1, Continued

(Dollars in Thousands)

	Sept 30, 2013	Sept 30, 2012	Sept 30, 2011	Inc (Dec) 2013	Inc (Dec) 2012
Revenues, Expenses, and Changes in Net Position					
Operating Revenues:					
Electric	\$ 25,597	\$ 25,238	\$ 25,172	\$ 359	\$ 66
Water and wastewater	374	-	-	374	-
Other	643	609	1,019	34	(410)
Recovery of (provision for) bad debts	(60)	(208)	1,193	148	(1,401)
Nonoperating revenue (expenses)	1,546	(718)	(336)	2,264	(382)
	<u>28,100</u>	<u>24,921</u>	<u>27,048</u>	<u>3,179</u>	<u>(2,127)</u>
Operating Expenses:					
Generation fuel	18,828	18,974	20,130	(146)	(1,156)
Generation other costs	2,949	3,083	2,686	(134)	397
Depreciation	2,245	1,758	1,833	487	(75)
Administration	1,159	1,154	1,104	5	50
Distribution and transmission	714	923	855	(209)	68
Engineering services	315	200	410	115	(210)
Renewable energy	106	100	98	6	2
Water and wastewater operations	1,113	-	-	1,113	-
Total operating expenses	<u>27,429</u>	<u>26,192</u>	<u>27,116</u>	<u>1,237</u>	<u>(924)</u>
Capital contributions	3,433	2,109	-	1,324	2,109
Special item: Net value of assets transferred	13,619	-	-	13,619	-
Extraordinary item: Loss from fire	-	(1,208)	-	1,208	(1,208)
Change in net position	17,723	(370)	(68)	18,093	(302)
Beginning net position	27,949	28,319	28,387	(370)	(68)
Ending net position	<u>\$ 45,672</u>	<u>\$ 27,949</u>	<u>\$ 28,319</u>	<u>\$ 17,723</u>	<u>\$ (370)</u>

Various factors contributed to current year's net change in Net Position as follows:

1. The recently implemented tariff (effective October 1, 2012) reflects current cost values and is better-designed to achieve operational viability. The adoption of the new tariff schedule by the PPUC Board of Directors was a positive move and expected to alleviate PPUC's financial challenges and improve corporate preparedness for the ongoing power generation and fuel market challenges.
2. A stabilized fuel market as indicated in the fuel price graph presented under Economic Factors and Outlook, has kept operating costs down.
3. Capital contributions from a donor country (Japan) for the new power plant exceeded \$3.4M for FY2013.
4. Net value of assets transferred from ROP for the Water and Wastewater Operations was nearly \$14M. In addition, PPUC received about \$2.7M of operating subsidies for the Water and Wastewater Operations.

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In order to better perceive significant changes during the year, if any, a three-year presentation of the financial position and revenues, expenses and changes in net position for each of the PPUC's operations are presented below in Tables 2 and 3:

Table 2: Electric Power Operation

(Dollars in Thousands)

	Sept 30, 2013	Sept 30, 2012	Sept 30, 2011	Inc (Dec) 2013	Inc (Dec) 2012
Statements of Net Position					
Current assets	\$ 17,017	\$ 16,682	\$ 20,479	\$ 335	\$ (3,797)
Other assets	271	228	203	43	25
Net utility plant	28,888	26,620	26,262	2,268	358
Total assets	46,176	43,530	46,944	2,646	(3,414)
Current liabilities	7,257	7,502	10,018	(245)	(2,516)
Other liabilities	7,541	8,079	8,607	(538)	(528)
Total liabilities	14,798	15,581	18,625	(783)	(3,044)
Net investment in capital assets	23,617	20,996	17,346	621	3,650
Unrestricted	7,761	6,953	10,973	808	(4,020)
Total net position	\$ 31,378	\$ 27,949	\$ 28,319	\$ 3,429	\$ (370)
Revenues, Expenses, and Changes in Net Position					
Operating Revenues:					
Electric	\$ 26,360	\$ 25,238	\$ 25,172	\$ 1,122	\$ 66
Others	643	609	1,019	34	(410)
Recovery (provision for) bad debts	(60)	(208)	1,193	148	(1,401)
Nonoperating Revenue (expense)	(1,127)	(718)	(336)	(409)	(382)
	25,816	24,921	27,048	895	(2,127)
Operating Expenses:					
Generation fuel	18,828	18,974	20,130	(146)	(1,156)
Generation other costs	2,950	3,083	2,686	(133)	397
Depreciation	1,803	1,758	1,833	45	(75)
Administration	1,095	1,154	1,104	(59)	50
Distribution and transmission	723	923	855	(200)	68
Engineering services	315	200	410	115	(210)
Renewable energy	106	100	98	6	2
Total Operating Expenses	25,820	26,192	27,116	(372)	(924)
Capital Contributions	3,433	2,109	-	1,324	2,109
Extraordinary Item: Loss from fire	-	(1,208)	-	1,208	(1,208)
Change in net position	3,429	(370)	(68)	3,799	(302)
Beginning net position	27,949	28,319	28,387	(370)	(68)
Ending net position	\$ 31,378	\$ 27,949	\$ 28,319	\$ 3,429	\$ (370)

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Changes to utility plant asset is discussed below under Capital Assets and Long-Term Debt. Electric sales increase is attributed to rate changes implemented through the newly adopted tariff schedule. Capital contributions are grants from Japan for the construction of a new power plant at Aimeliik equipped with two new 5MW baseload generators (FY2013) and acquisition of 4 smaller backup units in FY2012. The extraordinary loss last year was the value of assets damaged by a fire in November 2011.

Table 3: Water and Wastewater Operation
(Dollars in Thousands)

	Sept 30, 2013	Sept 30, 2012	Sept 30, 2011	Inc (Dec) 2013	Inc (Dec) 2012
Statements of Net Position					
Current assets	\$ 3,035			\$ 3,035	\$ -
Net utility plant	12,261	-	-	12,261	-
Total assets	15,296	-	-	15,296	-
Current liabilities	1,002	-	-	1,002	-
Total liabilities	1,002	-	-	1,002	-
Net investment in capital assets	12,262			12,262	-
Unrestricted	2,032	-	-	2,032	-
Total net position	\$ 14,294	\$ -	\$ -	\$ 14,294	\$ -
Revenues, Expenses, and Changes in Net Position					
Operating revenues:					
Water and wastewater	\$ 384	\$ -	\$ -	\$ 384	\$ -
Nonoperating revenue (expense)	2,673	-	-	2,673	-
Total revenue	3,057	-	-	3,057	-
Operating expenses:					
Water and wastewater	1,876	-	-	1,876	-
Depreciation	442	-	-	442	-
Administration	65	-	-	65	-
Total operating expenses	2,383	-	-	2,383	-
Special Item: Net value of assets transferred	13,620	-	-	13,620	-
Change in net position	14,294	-	-	14,294	-
Beginning net position	-	-	-	-	-
Ending net position	\$ 14,294	\$ -	\$ -	\$ 14,294	\$ -

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The statement of revenues, expenses and changes in net position reflect three months of operations from July 1 through September 30, 2013. ROP had appropriated funds for the start-up of the newly formed PWSC. Unexpended funds from this appropriation were transferred to PPUC, effected by the merger.

Significant cost components of the Water & Wastewater operating expenses are (in approximate percentages): electricity (40%), personnel (26%), consultant services (10%) and water chemicals (10%).

Assets and liabilities transferred were agreed to between ROP and PPUC with the effective date of July 1, 2013.

CAPITAL ASSETS and LONG-TERM DEBT

Capital Assets

PPUC realized significant capital injection this year in electric plants from a grant provided by a donor country (Japan) for four back-up generator units. Other smaller investments were made during the year to augment or replace aging equipment or structures. At the end of FY 2013, PPUC had invested in a broad range of utility capital assets, including its power generation plants, electric transmission and distribution infrastructure, and general support and administrative equipment. PPUC's investment in capital assets increased by \$14.5M to \$41.1M at the end of this fiscal year, inclusive of water and wastewater infrastructures transferred from ROP, net of depreciation. Refer below for details of this year's activities.

The following table summarizes PPUC's capital assets by category and accumulated depreciation, and the changes therein for the years ended September 30, 2013, 2012, and 2011, respectively.

CAPITAL ASSETS AND ACCUMULATED DEPRECIATION					
(Dollars in Thousands)					
	Sept 30, 2013	Sept 30, 2012	Sept 30, 2011	Increase (Decrease) 2013	Increase (Decrease) 2012
CAPITAL ASSETS:					
Electric Plants:					
Electric Plants, Koror/Aimeliik	\$ 26,513	\$ 28,340	\$ 29,280	\$ (1,827)	\$ (940)
Electric Plants, Outlying States	2,605	2,378	2,378	227	-
Total Electric Plants	29,118	30,718	31,658	1,600	(940)
Accumulated Depreciation	(13,784)	(17,951)	(17,866)	4,167	(85)
Net Electric Plant	15,334	12,767	13,792	2,567	(1,025)
Transmission & Distribution (T&D) System					
T&D System, Koror/Aimeliik	17,424	17,263	17,263	161	-
T&D System, Outlying States	2,090	2,090	2,090	-	-
Total T&D System	19,514	19,353	19,353	161	-
Accumulated Depreciation	(9,887)	(9,325)	(8,775)	(562)	(550)
Net T&D System	9,627	10,028	10,578	(401)	(550)
Water & Sewer Systems:					
Water Infrastructure	21,397	-	-	21,397	-
Sewer Infrastructure	19,407	-	-	19,407	-
Total Water & Sewer Systems	40,804	-	-	40,804	-
Accumulated Depreciation	(28,640)	-	-	(28,640)	-
Net Water & Sewer Systems	12,164	-	-	12,164	-

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CAPITAL ASSETS AND ACCUMULATED DEPRECIATION, CONTINUED
(Dollars in Thousands)

	Sept 30, 2013	Sept 30, 2012	Sept 30, 2011	Increase (Decrease) 2013	Increase (Decrease) 2012
Administrative Equipment:					
Buildings	\$ 1,576	\$ 1,424	\$ 1,399	\$ 152	\$ 25
Heavy Equipment & Vehicles	1,634	1,546	1,542	88	4
Tools & Maint Equipment	936	882	868	54	14
Computers & Office Equipment	755	644	647	111	(3)
Total Admin Equipment	4,901	4,496	4,456	405	40
Accumulated Depreciation	(3,044)	(2,868)	(2,782)	(176)	(86)
Net Admin Equipment	1,857	1,628	1,674	229	(46)
Capital Improvement Projects:					
500KW Mitsubishi Generators (4)	-	2,109	-	(2,109)	2,109
APP New Power Plant Groundworks	2,167	88	-	2,079	88
2MW CAT Generator	-	-	218	-	(218)
Total Capital Projects in Progress	2,167	2,197	218	(30)	1,979
TOTAL CAPITAL ASSETS, NET	\$ 41,149	\$ 26,620	\$ 26,262	\$ 14,529	\$ 358

The major Capital Improvement Project that was completed during the year was the four 500KW Mitsubishi generators at Malakal of \$ 2,109K.

Ongoing Capital Improvement Project is the APP New Power Plant of \$ 2,167K.

PPUC's capital improvement plans are based, in principle, on the master plan developed for PPUC in FY2009. The master plan identifies forward-looking strategies based on externally developed assumptions about PPUC's demographics and customer demands up to year 2025. The plan includes construction of a new power plant at Aimeliik with installation of six 5MW generators staggered every two years. The plan has been modified internally to include only the first two 5MW units, deferring the remaining units until an updated study can be made of energy demand and renewable energy plans.

PPUC is continuing its efforts to augment generation with alternative renewable energy. A new 225KW PV system was installed and commenced operation in October 2011, at the Palau International Airport parking lot. Transfer of ownership is pending execution of a Memorandum of Understanding with an affiliate, that was the official grant recipient. With this acquisition, plus existing third party renewable energy systems connected to the PPUC grid, total RE generation capacity add up to 377KW. Further studies and plans are underway for possible additional solar, wind and hydro systems for the main power grid, and hybrid systems for the Outlying States.

Please see note 7 to the financial statements for additional information regarding PPUC's capital assets.

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Long-Term Debt

At September 30, 2013, PPUC's loan portfolio comprised of the following:

	Original	At Sept 30, 2013
International Loan	\$ 7,000,000	\$ 5,400,000
Local Loan	\$ 3,000,000	\$ 2,678,546
TOTAL	\$ 10,000,000	\$ 8,078,546

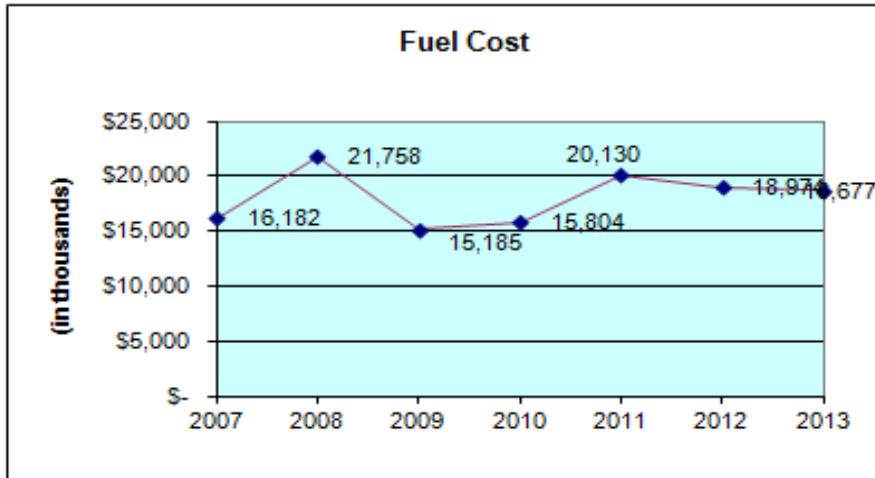
The above debts were acquired to purchase additional generation capacity and to finance major repairs and generation auxiliary equipment. Please see note 8 to the financial statements for additional information regarding PPUC's long-term debt.

ECONOMIC FACTORS and OUTLOOK

Fuel Market

Fuel costs make up over 70% of PPUC's operating costs. Due to size and location, PPUC's dependence on fossil fuel is likely to continue for several years and price volatility will continue to be a germane factor in PPUC's power supply scenario. PPUC's vulnerability is clear and efforts will continue to try and contain this risk.

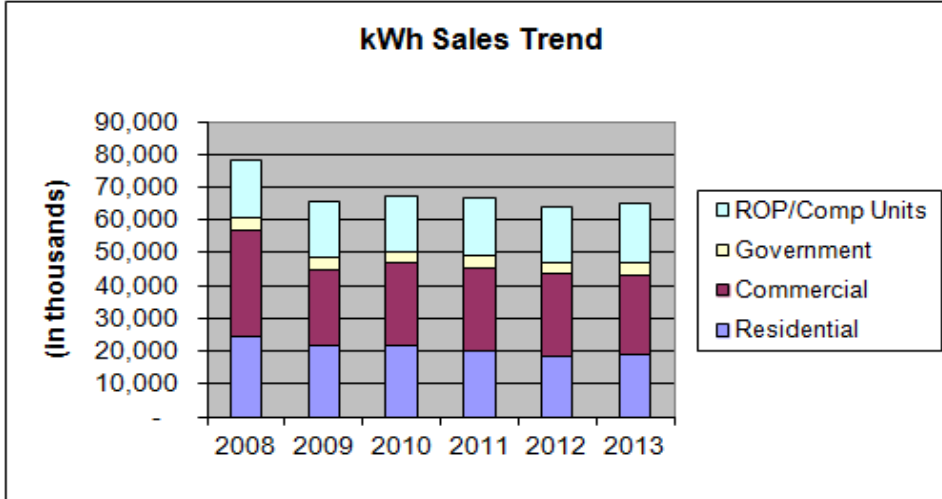
The cost trend of fuel for the past three years (excluding current fiscal year) almost mirror the previous three years (see chart below). This movement highlights the volatility of the market and PPUC's exposure.



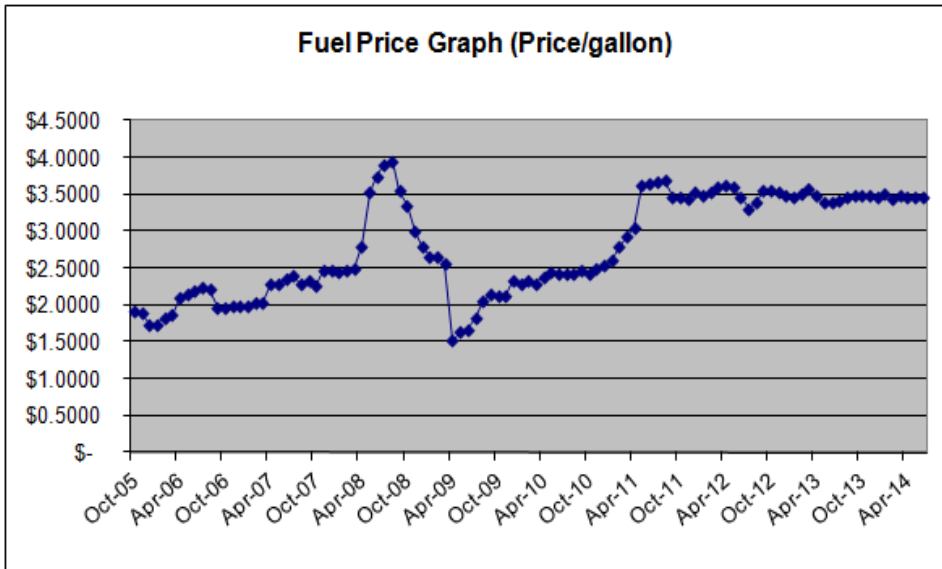
Fuel impact is evident in our sales performance. The steep price spike in the fuel market in 2008 provoked unforeseen energy conservation efforts which carried through 2009, resulting in a drop in sales by 16%. Steady sales through 2011 was disrupted by a 4% drop in consumption, apparently a reaction to resurgence of price escalation in 2011, which impelled further conservation measures. The chart below illustrates this impact on sales performance.

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Various factors drive gasoil prices. Tensions in the Middle East and economic outlook of the demand regions are contributing factors. These factors are unpredictable and erratic as seen in the graph below.



Unpredictability and volatility of the fuel market gives impetus to the drive for stable and controlled electric cost. Combined with global temperament towards environmental issues, these are making renewable energy a relevant, if not a significant, energy source in the future. PPUC is continuing its efforts, aided by development partners, to diversify its energy source and reduce dependence on fossil fuel.

Another dynamic on the energy scene in Palau is PPUC customers making entry into RE platforms in an effort to protect themselves from risks in the fossil market. To date, total photovoltaic systems installed at various establishments add up to approximately 1% of PPUC's total generation capacity, at KWp. Furthermore, various hotels have made significant investment in solar water heaters, reducing power consumption. This scenario reveals the energy market in Palau is becoming increasingly competitive.

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Management's Discussion and Analysis
Years Ended September 30, 2013 and 2012

Water & Wastewater Operation

On June 6, 2013, a bill was signed into law that consolidated the two independent public corporations, the PWSC and the PUC, under one corporate identity, the Palau Public Utilities Corporation. The intent of the Consolidation Act was to realize cost savings through synergies of administrative processes.

A significant operating cost of Water & Wastewater Operations is electricity for water and sewer pumps. This makes up roughly 40% of operating expenses. This cost is dependent on factors discussed above.

Palau is naturally blessed with rich water resources. PPUC's task is to harness, store and safeguard such resource to meet Palau's growing needs. Upgrade of systems and storage capacity, and efficient distribution together with effective monitoring and safeguarding mechanisms are challenges that management is actively pursuing with the support of Palau's leadership and donor partners.

FUTURE OUTLOOK

PPUC will continue to exert efforts towards the NEP targets of 30/20/20 (30% reduction of overall energy consumption and 20% renewable energy platforms by the year 2020). Renewable energy continues to attract development partners sympathetic to global warming issues. PPUC's efforts should focus on energy diversification and generation upgrades to assure energy supply stability and to benefit from cutting-edge technological advances.

Palau's economic outlook appears fair. Our tourism market appears to be stable based on visitor arrival statistics provided by the Palau Visitors Authority. Management is optimistic of a potentially robust economy and a commercially viable environment for the future.

ROP is re-negotiating new terms for a new Compact of Free Association (COFA) with the United States of America. Renewed COFA terms will assure the national government, and the local economy, of steady capital inflow to sustain current and spur new economic initiatives. This is a positive indicator as the national government is the single largest employer on island as well as a major player in Palau's economy.

CONTACTING PPUC'S FINANCIAL MANAGEMENT

This financial report is designed to provide PPUC's rate payers and creditors with a general overview of PPUC's finances and to demonstrate PPUC's accountability for the money it receives. Management's Discussion and Analysis for the year ended September 30, 2012 is set forth in PPUC's report on the audit of financial statements which is dated July 12, 2013. If you have questions about this report, or need additional information, contact the PPUC Accounting Department at the Palau Public Utilities Corporation, P.O. Box 1372, Koror, Republic of Palau 96940, or e-mail jalexander@PPUC.com or call 488-5320.

PALAU PUBLIC UTILITIES CORPORATION
(A Component Unit of the Republic of Palau)

Statements of Net Position
September 30, 2013 and 2012

<u>ASSETS</u>	<u>2013</u>	<u>2012</u>
Utility plant:		
Depreciable utility plant	\$ 38,982,276	\$ 24,423,327
Non-depreciable utility plant	2,166,962	2,196,741
Net utility plant	41,149,238	26,620,068
Current assets:		
Cash and cash equivalents	3,902,739	3,702,550
Restricted cash and cash equivalents	-	124,844
Receivables:		
Trade	3,316,119	2,836,726
Affiliate	3,050,850	1,311,610
Contracts	121,241	102,780
Other	69,294	31,686
	6,557,504	4,282,802
Less allowance for doubtful accounts	(471,000)	(410,000)
Net receivables	6,086,504	3,872,802
Prepaid expenses	691,016	290,098
Inventory, net	8,509,267	8,691,303
Due from grantor agencies	83,071	-
Total current assets	19,272,597	16,681,597
Other non-current assets:		
Contracts receivable, net of current portion	271,092	228,260
	\$ 60,692,927	\$ 43,529,925
<u>LIABILITIES AND NET POSITION</u>		
Net position:		
Net investment in capital assets	\$ 35,878,693	\$ 20,996,199
Unrestricted	9,793,331	6,953,195
Total net position	45,672,024	27,949,394
Commitments and contingencies		
Current liabilities:		
Current portion of long-term debt	537,508	527,601
Accounts payable	6,115,432	6,168,973
Accrued expenses	376,396	348,845
Customer deposits	450,529	456,665
Total current liabilities	7,479,865	7,502,084
Long-term debt, net of current portion	7,541,038	8,078,447
Total liabilities	15,020,903	15,580,531
	\$ 60,692,927	\$ 43,529,925

See accompanying notes to financial statements.

PALAU PUBLIC UTILITIES CORPORATION
(A Component Unit of the Republic of Palau)

Statements of Revenues, Expenses and Changes in Net Position
Years Ended September 30, 2013 and 2012

	2013	2012
Operating revenues:		
Power	\$ 25,597,453	\$ 25,237,736
Water and wastewater	373,745	-
Other	642,914	609,155
Total operating revenues	26,614,112	25,846,891
Provision for uncollectible receivables	(60,353)	(208,071)
Net operating revenues	26,553,759	25,638,820
Operating expenses:		
Generation - fuel	18,828,586	18,973,663
Generation - other cost	2,949,287	3,083,178
Depreciation	2,244,591	1,757,965
Administration	1,158,990	1,153,797
Distribution and transmission	714,051	922,759
Engineering services	314,560	200,365
Renewable energy	106,151	99,934
Water and wastewater operations	1,113,027	-
Total operating expenses	27,429,243	26,191,661
Operating loss	(875,484)	(552,841)
Nonoperating revenues (expenses):		
Operating subsidies from the Republic of Palau	2,672,734	-
Grants from the United States Government	345,258	-
Interest income	538	2,358
Gain (loss) on disposal of assets	250	(218,055)
Writedown of generators	(200,000)	-
Interest expense	(404,185)	(480,755)
Writedown of generation parts and supplies inventory	(870,000)	-
Other	1,440	(20,972)
Total nonoperating revenues (expenses), net	1,546,035	(717,424)
Earnings (loss) before capital contributions, special and extraordinary items	670,551	(1,270,265)
Capital contributions:		
Grants from the Japan Government	3,432,642	2,109,104
Special item:		
Transfer of water and wastewater operations at carrying value	13,619,437	-
Extraordinary item:		
Loss on disposal of assets related to a catastrophic fire	-	(1,208,189)
Change in net position	17,722,630	(369,350)
Net position at beginning of year	27,949,394	28,318,744
Net position at end of year	\$ 45,672,024	\$ 27,949,394

See accompanying notes to financial statements.

PALAU PUBLIC UTILITIES CORPORATION
(A Component Unit of the Republic of Palau)

Statements of Cash Flows
Years Ended September 30, 2013 and 2012

	2013	2012
Cash flows from operating activities:		
Cash received from customers	\$ 26,614,392	\$ 28,776,561
Cash payments to suppliers for goods and services	(23,242,758)	(23,445,933)
Cash payments to employees for services	(2,695,262)	(2,209,644)
Net cash provided by operating activities	676,372	3,120,984
Cash flows from investing activities:		
Net change in restricted cash	124,844	83,063
Interest and dividends on investments and restricted cash	538	2,358
Other non-operating	1,440	12,025
Net cash provided by investing activities	126,822	97,446
Cash flows from non-capital financing activities:		
Appropriations received from the Republic of Palau	1,288,390	-
Cash received from grantor agencies	262,187	10,500
Net cash provided by non-capital financing activities	1,550,577	10,500
Cash flows from capital and related financing activities:		
Principal payment on long-term debt	(527,502)	(519,003)
Interest paid on long-term debt	(346,606)	(480,101)
Acquisition of utility plant	(1,279,474)	(436,352)
Net cash used for capital and related financing activities	(2,153,582)	(1,435,456)
Net change in cash and cash equivalents	200,189	1,793,474
Cash and cash equivalents at beginning of year	3,702,550	1,909,076
Cash and cash equivalents at end of year	\$ 3,902,739	\$ 3,702,550
Reconciliation of operating loss to net cash provided by operating activities:		
Operating loss	\$ (875,484)	\$ (552,841)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Depreciation	2,244,591	1,757,965
Provision for uncollectible receivables	60,353	208,071
(Increase) decrease in assets:		
Receivables:		
Trade	(238,416)	(538,104)
Affiliate	343,733	3,352,131
Contracts	(61,293)	77,807
Other	(37,608)	10,796
Prepaid expenses	7,565	230,973
Inventory	(584,547)	1,100,771
Increase (decrease) in liabilities:		
Accounts payable	(146,358)	(2,546,768)
Accrued expenses	(30,028)	(6,857)
Customer deposits	(6,136)	27,040
Net cash provided by operating activities	\$ 676,372	\$ 3,120,984

Non-cash transactions:

In 2013 and 2012, PPUC received \$3,432,642 and \$2,109,104, respectively, in grants from the Japan Government consisting of various utility plant equipment and related costs of installation.

In 2013, as a result of the transfer of the water and wastewater operations, PPUC received various assets and liabilities with net carrying value of \$12,920,808.

In 2012, the Republic of Palau (ROP) purchased a generator on behalf of PPUC at a cost of \$996,000 which was offset against ROP's outstanding receivables.

PALAU PUBLIC UTILITIES CORPORATION
(A Component Unit of the Republic of Palau)

Notes to Financial Statements
September 30, 2013 and 2012

(1) Organization

The Public Utilities Corporation (PUC), a component unit of the Republic of Palau (ROP), was created on July 6, 1994, under the provisions of Republic of Palau Public Law (RPPL) 4-13. The law created a wholly-owned government corporation governed by a Board of Directors appointed by the President of the ROP, with the advice and consent of the Senate of the Olbiil Era Kelulau (ROP National Congress). The primary purpose of PUC is to establish and operate electrical utility services within ROP.

On June 6, 2013, RPPL 9-4 was signed into law for the purpose of merging the Palau Water & Sewer Corporation and PUC operations as Palau Public Utilities Corporation (PPUC). The electric power (EPO) and water and wastewater (WWO) operations are to be treated as separate business segments having their own organizational chart delineating its chain of management. Further, shared administrative costs and expertise are to be allocated between EPO and WWO and shall not be utilized to subsidize each other.

On July 16, 2013, a memorandum of understanding was agreed by PPUC and the ROP Ministry of Finance (ROP-MOF) to delineate certain arrangements and conditions under which ROP-MOF shall provide accounting processing services to WWO while it is being established as a business segment of PPUC accounting systems. On February 24, 2014, PPUC and ROP-MOF formalized the transfer of all assets and liabilities of WWO and established the effective date of transfer to be July 1, 2013. While the law effected a merger date of June 6, 2013, PPUC and ROP-MOF agreed that intervening transactions in between that date to July 1, 2013 were not material to the financial statements.

PPUC's financial statements are incorporated into the financial statements of ROP as a component unit.

(2) Summary of Significant Accounting Policies

Basis of Accounting

The accounting policies of PPUC conform to accounting principles generally accepted in the United States of America (GAAP), as applicable to governmental entities, specifically proprietary funds. PPUC utilizes the flow of economic resources measurement focus. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

Accounting Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, demand deposits and time certificates of deposit with original maturities of three months or less.

PALAU PUBLIC UTILITIES CORPORATION
(A Component Unit of the Republic of Palau)

Notes to Financial Statements
September 30, 2013 and 2012

(2) Summary of Significant Accounting Policies, Continued

Receivables

PPUC grants credit, on an unsecured basis, to individuals, businesses and governmental entities situated in the Republic of Palau. The allowance for doubtful accounts is stated at an amount which management believes will be adequate to absorb possible losses on accounts receivable that may become uncollectible based on evaluation of the collectability of these accounts and prior collection experience. The allowance is established through a provision for uncollectible receivables charged to expense.

Inventory

Inventories of fuel and supplies are stated at the lower of cost (first-in, first-out) or market (net realizable value).

Utility Plant

Utility plant purchased or constructed is stated at cost. Donated utility plant is recorded at fair market value at the date of donation or at the donating entity's basis in the asset if donated by ROP or an ROP agency. PPUC capitalizes utility plant with a cost of \$500 or more.

Depreciation is computed using the straight-line method over the estimated useful lives of the respective assets.

PPUC capitalizes interest in order to recognize all costs associated with construction based on PPUC's weighted average borrowing rate.

Net Position

Net position represents the residual interest in PPUC's assets after liabilities are deducted and consist of four sections:

Net investment in capital assets – include capital assets, restricted and unrestricted, net of accumulated depreciation, reduced by outstanding debt net of debt service reserve.

Restricted expendable – net position whose use is subject to externally imposed stipulations that can be fulfilled by actions of PPUC pursuant to those stipulations or that expire with the passage of time.

Restricted nonexpendable – net position subject to externally imposed stipulations that require PPUC to maintain them permanently.

Unrestricted – net position that is not subject to externally imposed stipulations. Unrestricted net position may be designated for specific purposes by management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

PALAU PUBLIC UTILITIES CORPORATION
(A Component Unit of the Republic of Palau)

Notes to Financial Statements
September 30, 2013 and 2012

(2) Summary of Significant Accounting Policies, Continued

Sales of Electricity

Sales of electricity, water and wastewater services are recorded as billed to customers on a monthly cycle billing basis. At the end of each month, unbilled revenues are accrued for each cycle based on the most recent cycle billing. Unbilled revenues at September 30, 2013 and 2012 were \$1,765,962 and \$1,490,559, respectively.

Operating and Non-Operating Revenues and Expenses

Operating revenues and expenses include all direct and administrative revenues and expenses associated with the generation and distribution of electricity and water to customers in the Republic of Palau.

Non-operating revenues and expenses result from investing and financing activities, including operating and capital grants from other governmental entities.

Retirement Plan

PPUC contributes to the Palau Civil Service Pension Trust Fund (the Fund), a defined benefit, cost-sharing, multiple employer pension plan established and administered by the Republic of Palau.

The Fund provides retirement, security and other benefits to employees, and their spouses and dependents, of the Republic of Palau, Republic of Palau State Governments and Republic of Palau agencies, funds and public corporations, which are paid monthly and are two percent of each member's average monthly salary. Normal benefits are the credited total service up to a maximum of thirty years total service. Generally, benefits vest after three years of credited service. Members who retire at or after age 60, or with 25 years of vesting service, are entitled to retirement benefits. RPPL 2-26 is the authority under which benefit provisions are established. Member contribution rates are established by RPPL 2-26 at six percent (6%) of total payroll and matched dollar for dollar by the employer. PPUC contributed \$122,322, \$102,092 and \$103,690 to the Fund during the fiscal years 2013, 2012 and 2011, respectively, which was equal to the required contributions for the respective years then ended.

Under the provisions of RPPL 2-26, the Fund's Board of Trustees adopted a Trust Fund Operation Plan which has the force and effect of law and which sets forth the procedures for the administration and coverage of the Plan. Amendments to the Plan are subject to the requirements of Title 6 of the Palau National Code. PPUC's total payroll, except expatriate workers, for fiscal years 2013 and 2012 is covered by the Fund's plan. The Fund utilizes the actuarial cost method termed "aggregate cost method" with actuarial assumptions used to compute the pension benefit obligation as follows: (a) a rate of return of 8.5% per year on the investment of present and future assets, (b) a 3% increase in employee salaries until retirement, and (c) members are assumed to retire at their normal retirement date.

The pension benefit obligation, which is the actuarial present value of credited projected benefits, is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and any step-rate benefits, estimated to be payable in the future as a result of employment service to date. The measure is intended to assist users to evaluate the Fund's funding status on a going-concern basis, and evaluate progress made in accumulating adequate assets to pay benefits when due.

PALAU PUBLIC UTILITIES CORPORATION
(A Component Unit of the Republic of Palau)

Notes to Financial Statements
September 30, 2013 and 2012

(2) Summary of Significant Accounting Policies, Continued

Retirement Plan, Continued

The Fund's October 1, 2011 actuarial valuation determined the unfunded pension benefit obligation as follows:

Participants in pay status	\$ 62,987,516
Active participants	74,716,975
Participants with vested deferred benefits	<u>2,323,366</u>
Total pension benefit obligation	140,027,857
Net assets available for benefits, at market value	<u>(36,128,666)</u>
Unfunded benefit obligation	\$ <u>103,899,191</u>

The actuarial valuation did not provide a breakdown of actuarial present value of vested and non-vested accumulated plan benefits by sponsor or net position available for benefits by sponsor.

The Fund issues a publicly available financial report that includes financial statements and required supplemental information. That report may be obtained by writing to the Republic of Palau Civil Service Pension Plan, P.O. Box 1767, Koror, Palau 96940.

Taxes

Based on enactment of RPPL 4-13 and RPPL 9-4, PPUC is exempt from all national and state non-payroll taxes or fees.

Compensated Absences

Accumulated unpaid annual leave is accrued when earned and is included in the statements of net position as an accrued expense. Accumulated unused sick pay benefit is accrued at 25% of the sick leave hours recorded times the employee regular base rate, and is included in the statements of net position as an accrued expense.

New Accounting Standards

During the year ended September 30, 2013, PPUC implemented the following pronouncements:

- GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, which addressed how to account for and report service concession arrangements (SCAs), a type of public-private or public-public partnership that state and local governments are increasingly entering into. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 61, *The Financial Reporting Entity: Omnibus*, which improved financial reporting for governmental entities by amending the requirements of Statements No. 14, *The Financial Reporting Entity*, and No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, to better meet user needs and address reporting entity issues that have come to light since those Statements were issued in 1991 and 1999, respectively. The implementation of this statement did not have a material effect on the accompanying financial statements.

PALAU PUBLIC UTILITIES CORPORATION
(A Component Unit of the Republic of Palau)

Notes to Financial Statements
September 30, 2013 and 2012

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

- GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which enhanced the usefulness of its Codification by incorporating guidance that previously could only be found in certain Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA) pronouncements issued on or before November 30, 1989, which does not conflict or contradict GASB pronouncements. GASB Statement No. 62 superseded GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, which established guidance for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position, and GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, which clarifies the appropriate reporting of deferred outflows of resources and deferred inflows of resources to ensure consistency in financial reporting. These Statements amend the net asset reporting requirements in Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, and other pronouncements by incorporating deferred outflows of resources and deferred inflows of resources into the definitions of the required components of the residual measure and by renaming that measure as net position, rather than net assets. With the implementation of GASB Statement No. 63 and Statement No. 65, the Statement of Net Assets was renamed the Statement of Net Position. In addition, the Statement of Net Position includes two new classifications separate from assets and liabilities. Amounts reported as deferred outflows of resources are reported in a separate section following assets. Likewise, amounts reported as deferred inflows of resources are reported in a separate section following liabilities. The implementation of this statement did not have a material effect on the accompanying financial statements.

In April 2012, GASB issued Statement No. 66, *Technical Corrections - 2012*, which enhances the usefulness of financial reports by resolving conflicting accounting and financial reporting guidance that could diminish the consistency of financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has not yet determined the effect of implementation of this statement on the financial statements of PPUC.

In June 2012, GASB issued Statement No. 67, *Financial Reporting for Pension Plans*, which revises existing guidance for the financial reports of most pension plans, and Statement No. 68, *Accounting and Financial Reporting for Pensions*, which revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. The provisions in Statement 67 are effective for financial statements for periods beginning after June 15, 2013. The provisions in Statement 68 are effective for fiscal years beginning after June 15, 2014. Management has not yet determined the effect of implementation of these statements on the financial statements of PPUC.

PALAU PUBLIC UTILITIES CORPORATION
(A Component Unit of the Republic of Palau)

Notes to Financial Statements
September 30, 2013 and 2012

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In January 2013, GASB issued Statement No. 69, *Government Combinations and Disposals of Government Operations*, which improves accounting and financial reporting for state and local governments' combinations and disposals of government operations. Government combinations include mergers, acquisitions, and transfers of operations. A disposal of government operations can occur through a transfer to another government or a sale. The provisions in Statement 69 are effective for fiscal years beginning after December 15, 2013. Management has not yet determined the effect of implementation of this statement on the financial statements of PPUC.

In April 2013, GASB issued Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, which requires a state or local government guarantor that offers a nonexchange financial guarantee to another organization or government to recognize a liability on its financial statements when it is more likely than not that the guarantor will be required to make a payment to the obligation holders under the agreement. The provisions in Statement 70 are effective for fiscal years beginning after June 15, 2013. Management has not yet determined the effect of implementation of this statement on the financial statements of PPUC.

(3) Cash and Cash Equivalents and Restricted Cash and Cash Equivalents

Cash and Cash Equivalents

Custodial credit risk is the risk that in the event of a bank failure, PPUC's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. PPUC does not have a deposit policy for custodial credit risk.

As of September 30, 2013 and 2012, cash and cash equivalents and restricted cash equivalents were \$3,902,739 and \$3,827,394, respectively, and the corresponding bank balances were \$3,977,635 and \$3,901,920, respectively. Of these amounts, \$3,604,846 and \$3,443,116, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance; while \$372,789 and \$458,804 as of September 30, 2013 and 2012, respectively, are held and administered by investment managers subject to Securities Investor Protection Corporation Insurance. As of September 30, 2013 and 2012, bank deposits of \$618,732 and \$1,894,129, respectively, were FDIC insured. PPUC does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC coverage and deposits in financial institutions not subject to FDIC coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk.

Restricted Cash and Cash Equivalents

PPUC's restricted cash and cash equivalents of \$124,844 as of September 30, 2012 represent the unspent portion of proceeds from PPUC's loan with a foreign bank (see note 8).

PALAU PUBLIC UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2013 and 2012

(4) Grants

U.S. Federal Government:

PPUC is a subrecipient of federal grants received by ROP from a U.S. federal agency. Excess grant disbursements over receipts are recognized as due from grantor agencies until funds are received in accordance with grant terms and conditions.

Japan Government:

On March 2, 2012, the Japan Government awarded emergency grant aid of up to 300,000,000 yen, or approximately \$3,000,000 at the date of award, for the purpose of contributing to the implementation of an emergency measure against a power crisis in November 2011. On March 5, 2012, PPUC entered into an agent agreement (the Agreement) with Japan International Cooperation System, a Japan non-for-profit organization in charge of procurement services in Grant Aid and Technical Cooperation, to be its procurement agent as a requirement of the grant. Proceeds from the grant were used to fund utility plant related projects (see note 7).

On June 27, 2012, the Japan Government provided a grant for the Enhancing Power Generation Capacity in the Urban Area in the Republic of Palau (the Project) for 1,729,000,000 yen or approximately \$21,700,000 at the date of award. The Project involves the rebuilding of the Aimeliik Power Plant. As part of the grant, PPUC entered into an agreement with a consultant on July 16, 2012 to provide professional services for design, assistance of tendering, and supervision of the Project and with a contractor on November 26, 2012 for the construction of the new Aimeliik Power Plant.

Changes in the due from grantor agency accounts for the years ended September 30, 2013 and 2012 are as follows:

	<u>2013</u>	<u>2012</u>
Balance at beginning of year	\$ -	\$ 10,500
Additions - program outlays:		
U.S. Federal Government	345,258	-
Japan Government	<u>3,432,642</u>	<u>2,109,104</u>
	<u>3,777,900</u>	<u>2,119,604</u>
Deductions:		
Cash receipts from the U.S. Federal Government	(265,787)	(10,500)
Capitalized cost from the Japan Government grants	<u>(3,429,042)</u>	<u>(2,109,104)</u>
	<u>(3,694,829)</u>	<u>(2,119,604)</u>
Balance at end of year	\$ <u>83,071</u>	\$ <u>-</u>

(5) Receivable from a Local Bank

At September 30, 2013 and 2012, PPUC has uninsured deposits of \$2,025,381 with a bank that went into receivership on November 7, 2006. These deposits were fully provided for with an allowance at September 30, 2013 and 2012.

PALAU PUBLIC UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2013 and 2012

(6) Inventory

Inventory at September 30, 2013 and 2012, consists of the following:

	<u>2013</u>	<u>2012</u>
Generation parts and supplies	\$ 5,946,838	\$ 5,091,522
Fuel	3,358,689	3,804,152
Lubricants	31,132	27,295
Chemicals	253,436	-
Water distribution parts and supplies	<u>20,838</u>	<u>-</u>
	9,610,933	8,922,969
Provision for slow moving and obsolete inventory	<u>(1,101,666)</u>	<u>(231,666)</u>
	<u>\$ 8,509,267</u>	<u>\$ 8,691,303</u>

Provision for slow moving and obsolete inventory of \$870,000 at September 30, 2013 was provided for generation parts and supplies inventory that are maintained in the Aimeliik power plant that caught fire in November 2011.

(7) Utility Plant

Utility plant consists of the following detailed balances at September 30, 2013 and 2012:

	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2012</u>	<u>Additions and Transfers</u>	<u>Deletions and Transfers</u>	<u>Balance at September 30, 2013</u>
Depreciable utility plant:					
Electric plant	3 - 25 years	\$ 30,718,056	\$ 3,768,830	\$ (5,368,808)	\$ 29,118,078
Water system	20 years	-	21,397,218	-	21,397,218
Sewer system	20 years	-	19,406,631	-	19,406,631
General support equipment	2 - 30 years	23,302,289	506,298	(52,632)	23,755,955
Administrative equipment	2 - 10 years	<u>547,319</u>	<u>133,349</u>	<u>(21,809)</u>	<u>658,859</u>
		54,567,664	45,212,326	(5,443,249)	94,336,741
Less accumulated depreciation		<u>(30,144,337)</u>	<u>(30,453,377)</u>	<u>5,243,249</u>	<u>(55,354,465)</u>
		24,423,327	14,758,949	(200,000)	38,982,276
Non-depreciable utility plant:					
Construction in progress		<u>2,196,741</u>	<u>4,163,520</u>	<u>(4,193,299)</u>	<u>2,166,962</u>
		<u>\$ 26,620,068</u>	<u>\$ 18,922,469</u>	<u>\$ (4,393,299)</u>	<u>\$ 41,149,238</u>
	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2011</u>	<u>Additions and Transfers</u>	<u>Deletions and Transfers</u>	<u>Balance at September 30, 2012</u>
Depreciable utility plant:					
Electric plant	3 - 25 years	\$ 31,658,415	\$ 1,068,714	\$ (2,009,073)	\$ 30,718,056
General support equipment	2 - 30 years	23,279,285	164,575	(141,571)	23,302,289
Administrative equipment	2 - 10 years	<u>529,495</u>	<u>111,425</u>	<u>(93,601)</u>	<u>547,319</u>
		55,467,195	1,344,714	(2,244,245)	54,567,664
Less accumulated depreciation		<u>(29,422,429)</u>	<u>(1,757,965)</u>	<u>1,036,057</u>	<u>(30,144,337)</u>
		26,044,766	(413,251)	(1,208,188)	24,423,327
Non-depreciable utility plant:					
Construction in progress		<u>218,055</u>	<u>2,196,741</u>	<u>(218,055)</u>	<u>2,196,741</u>
		<u>\$ 26,262,821</u>	<u>\$ 1,783,490</u>	<u>\$ (1,426,243)</u>	<u>\$ 26,620,068</u>

PALAU PUBLIC UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2013 and 2012

(7) Utility Plant, Continued

Included in the additions and transfers as of September 30, 2013 are utility plant assets upon merger of WWO (see note 1) as follows:

Water system	\$ 21,397,218
Sewer system	19,406,631
General support equipment	94,892
Administrative equipment	<u>13,415</u>
	40,912,156
Less accumulated depreciation	<u>28,650,761</u>
	\$ <u>12,261,395</u>

At September 30, 2013 and 2012, construction in progress included \$1,991,000 and \$2,109,104, respectively, of Japan Government funded projects (see note 4).

In November 2011, the Aimeliik power plant caught fire resulting in damage to several generators and to the plant building. In March 2012, PPUC decided that the damaged generators will not be rehabilitated and will be sold while the cost of the plant building was written down and the other damaged equipment were disposed of. The loss resulting from the aforementioned disposals and write downs totaled \$1,208,189 at September 30, 2012 and is presented as loss on disposal of assets related to a catastrophic fire in the accompanying statements of revenues, expenses and changes in net position. At September 30, 2013, based on evaluation of potential recoverability of the damaged generators held for sale, PPUC recorded a further write down of \$200,000 of the assets' carrying value which is included in the nonoperating revenues (expenses) in the accompanying statements of revenues, expenses and changes in net position.

(8) Long-Term Debt

On September 4, 2006, PPUC entered into a loan with a foreign bank not to exceed \$7,000,000 with interest at 3.5% per annum to finance the purchase of portable generators, a crankshaft assembly and other necessary equipment to facilitate the overhaul of aging generators. The loan is guaranteed by the Republic of Palau and is to be repaid in thirty-five consecutive semi-annual principal installments of \$200,000 plus interest; the first installment being repaid on the last day of the thirty-sixth month from the date of the initial advance and thereafter semi-annually on the last day of each successive six-month period, until fully paid.

On April 21, 2010, PPUC entered into a loan with a development bank, an affiliated organization, for \$3,000,000 to finance the purchase of two generator sets. The loan is collateralized by the generator sets inclusive of auxiliary equipment. The loan bears interest of 7.5% per annum and is to be repaid monthly beginning January 30, 2011 in principal and interest payments of \$27,810. Payment of interest during the eight month grace period was spread over twelve months with an equal payment of \$12,500 per month starting January 30, 2011.

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September 30, 2013 and 2012

(8) Long-Term Debt, Continued

Principal payments for subsequent years ending September 30 and applicable interest due, are as follows:

<u>Year Ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2014	\$ 537,508	\$ 379,987	\$ 917,495
2015	548,182	355,118	903,300
2016	559,183	330,350	889,533
2017	572,043	302,867	874,910
2018	585,399	275,317	860,716
2019 - 2023	3,166,150	924,786	4,090,936
2024 - 2027	<u>2,110,081</u>	<u>150,481</u>	<u>2,260,562</u>
	<u>\$ 8,078,546</u>	<u>\$ 2,718,906</u>	<u>\$ 10,797,452</u>

Movements in long-term liabilities for the years ended September 30, 2013 and 2012, are as follows:

	<u>Balance at October 1, 2012</u>	<u>Additions</u>	<u>Repayments</u>	<u>Balance at September 30, 2013</u>	<u>Balance Due in One Year</u>
Long-term debt	\$ <u>8,606,048</u>	\$ <u> -</u>	\$ <u>(527,502)</u>	\$ <u>8,078,546</u>	\$ <u>537,508</u>
	<u>Balance at October 1, 2011</u>	<u>Additions</u>	<u>Repayments</u>	<u>Balance at September 30, 2012</u>	<u>Balance Due in One Year</u>
Long-term debt	\$ <u>9,125,051</u>	\$ <u> -</u>	\$ <u>(519,003)</u>	\$ <u>8,606,048</u>	\$ <u>527,601</u>

(9) Related Party Transactions

Sale of Utility Services

Utility services of \$6,898,072 and \$7,097,470 were rendered to ROP for the years ended September 30, 2013 and 2012, respectively. PPUC provides electrical and water utility services to ROP at the same rates charged to third parties.

Receivables of \$967,877 and \$1,311,610 (excluding unbilled receivable of \$505,307 and \$390,189 as of September 30, 2013 and 2012, respectively) are due from ROP for utility services as of September 30, 2013 and 2012, respectively, and are included in the receivable from affiliate in the accompanying statements of net position. Of these receivables, \$166,822 and \$20,509 as of September 30, 2013 and 2012, respectively, have been outstanding for more than ninety days.

Merger of WWO

As part of the transfer agreement of the WWO operations (see note 1), ROP was to transfer all grants, appropriations and authorized loan proceeds to PPUC to cover operating costs. For the year ended September 30, 2013, PPUC recognized \$2,672,734 of operating subsidies from ROP as a result of the agreement. As of September 30, 2013, \$2,082,973 remains uncollected and is included in receivables from affiliate in the accompanying statements of net position.

PALAU PUBLIC UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2013 and 2012

(9) Related Party Transactions, Continued

Merger of WWO, Continued

In addition to the above, certain utility plant improvements in Koror, Melekeok and Elechui are to be transferred to PPUC at a later date as ROP is in the process of concluding work on these utility plant improvements.

Others

In October 2007, PPUC entered into a Maintenance Agreement with the National Government of Palau for a period of ten years in line with ROP's utilization of alternative energy technology to reduce dependence on petroleum based fuel products through the installation of solar photovoltaic systems (PV systems). Under the agreement, the National Government shall provide necessary equipment, execute all documents required for receipt of the project resources, and coordinate with the contractor. ROP shall also pay PPUC the energy charge produced by the PV systems and PPUC shall in turn use the payment for maintenance, repair and replacement of components of the PV systems. However, any excess cost incurred in the maintenance, repair and replacement of the PV system shall be borne by ROP. For the years ended September 30, 2013 and 2012, the energy charge incurred by ROP was \$50,606 and \$42,798, respectively.

(10) Commitments

Lease

PPUC entered into an agreement on October 14, 1999 with the Republic of Palau, State of Koror and Koror State Public Land Authority, in which PPUC is granted the use and exclusive possession of real property located in Malakal (on which the Malakal Power Plant is located) for a term of thirty years. PPUC is not required to pay rent or fees for its use of the property.

Fuel Supply

In 2011, PPUC renewed its agreement with a contractor effective until December 31, 2016 for the purchase of production fuel. Purchase price for the agreement is based on movements of the base price for fuel.

In March 2014, PPUC entered into a 5-year fuel supply contract with another contractor for the purchase of production fuel and vehicle fuel and lubricants. Purchase price for the agreement are based on movements of the base price for fuel and lubricants.

(11) Contingencies

PPUC currently does not maintain insurance coverage with respect to its inventory and utility plant. In the event of a loss, PPUC will be self-insured for the entire amount (see note 12).

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Notes to Financial Statements
September 30, 2013 and 2012

(11) Contingencies, Continued

Under the provisions of RPPL 4-51, PPUC shall credit from future electric utility charges the actual cost, including freight and insurance, incurred by any non-governmental electric utility customer, or incurred by any state government customer prior to the transfer of the Aimeliik Power Plant to PPUC, to purchase transformers, cables, and meter bases necessary to connect such customer to the electric power distribution system; provided, however, that the customer is not entitled to such credit unless it has obtained written confirmation from PPUC that the types of transformers, cables and meter bases are suitable to connect the customer to the electric power distribution system and that the proposed cost is reasonable. The expected credit from future electric utility charges cannot be presently determined and, accordingly, no provision for any credit has been recognized in the accompanying financial statements.

(12) Risk Management

PPUC is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. PPUC has elected to purchase commercial insurance from independent third parties for the risks of loss to which it is exposed, except for inventory and utility plant. Settled claims from insured risks have not exceeded commercial insurance coverage in the past three years. However, PPUC recorded a loss from a fire at the Aimeliik Power Plant of \$1,208,189 on November 2011.

(13) Dependency on the Republic of Palau

WWO incurred an operating loss of \$2,440,531 for the three months ended September 30, 2013. As WWO operations are primarily funded by ROP subsidies, management believes that its ability to finance future WWO operations is dependent on continued adequate funding from ROP.

PALAU PUBLIC UTILITIES CORPORATION
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Combining Statement of Net Position
September 30, 2013

<u>ASSETS</u>	<u>Electric Power Operations</u>	<u>Water and Wastewater Operations</u>	<u>Eliminations</u>	<u>Total</u>
Utility plant:				
Depreciable utility plant	\$ 26,720,881	\$ 12,261,395	\$ -	\$ 38,982,276
Non-depreciable utility plant	<u>2,166,962</u>	<u>-</u>	<u>-</u>	<u>2,166,962</u>
Net utility plant	<u>28,887,843</u>	<u>12,261,395</u>	<u>-</u>	<u>41,149,238</u>
Current assets:				
Cash and cash equivalents	3,899,227	3,512	-	3,902,739
Receivables:				
Trade	3,075,789	240,330	-	3,316,119
Affiliate	1,746,983	2,082,973	(779,106)	3,050,850
Contracts	121,241	-	-	121,241
Other	<u>63,757</u>	<u>5,537</u>	<u>-</u>	<u>69,294</u>
	5,007,770	2,328,840	(779,106)	6,557,504
Less allowance for doubtful accounts	<u>(471,000)</u>	<u>-</u>	<u>-</u>	<u>(471,000)</u>
Net receivables	<u>4,536,770</u>	<u>2,328,840</u>	<u>(779,106)</u>	<u>6,086,504</u>
Prepaid expenses	262,986	428,030	-	691,016
Inventory, net	8,234,994	274,273	-	8,509,267
Due from grantor agency	<u>83,071</u>	<u>-</u>	<u>-</u>	<u>83,071</u>
Total current assets	<u>17,017,048</u>	<u>3,034,655</u>	<u>(779,106)</u>	<u>19,272,597</u>
Other non-current assets:				
Contracts receivable, net of current portion	<u>271,092</u>	<u>-</u>	<u>-</u>	<u>271,092</u>
	<u>\$ 46,175,983</u>	<u>\$ 15,296,050</u>	<u>\$ (779,106)</u>	<u>\$ 60,692,927</u>
 <u>LIABILITIES AND NET POSITION</u> 				
Net position:				
Net investment in capital assets	\$ 23,617,298	\$ 12,261,395	\$ -	\$ 35,878,693
Unrestricted	<u>7,761,110</u>	<u>2,032,221</u>	<u>-</u>	<u>9,793,331</u>
Total net position	<u>31,378,408</u>	<u>14,293,616</u>	<u>-</u>	<u>45,672,024</u>
Commitments and contingencies				
Current liabilities:				
Current portion of long-term debt	537,508	-	-	537,508
Accounts payable	5,906,378	988,160	(779,106)	6,115,432
Accrued expenses	362,122	14,274	-	376,396
Customer deposits	<u>450,529</u>	<u>-</u>	<u>-</u>	<u>450,529</u>
Total current liabilities	<u>7,256,537</u>	<u>1,002,434</u>	<u>(779,106)</u>	<u>7,479,865</u>
Long-term debt, net of current portion	<u>7,541,038</u>	<u>-</u>	<u>-</u>	<u>7,541,038</u>
Total liabilities	<u>14,797,575</u>	<u>1,002,434</u>	<u>(779,106)</u>	<u>15,020,903</u>
	<u>\$ 46,175,983</u>	<u>\$ 15,296,050</u>	<u>\$ (779,106)</u>	<u>\$ 60,692,927</u>

See accompanying independent auditors' report.

PALAU PUBLIC UTILITIES CORPORATION
(A Component Unit of the Republic of Palau)

Combining Statement of Revenues, Expenses and Change in Net Position
Year Ended September 30, 2013

	Electric Power Operations	Water and Wastewater Operations	Eliminations	Total
Operating revenues:				
Power	\$ 26,360,007	\$ -	\$ (762,554)	\$ 25,597,453
Water and wastewater	-	384,147	(10,402)	373,745
Other	642,914	-	-	642,914
Total operating revenues	27,002,921	384,147	(772,956)	26,614,112
Provision for uncollectible receivables	(60,353)	-	-	(60,353)
Net operating revenues	26,942,568	384,147	(772,956)	26,553,759
Operating expenses:				
Generation - fuel	18,828,586	-	-	18,828,586
Generation - other cost	2,949,702	-	(415)	2,949,287
Depreciation	1,802,616	441,975	-	2,244,591
Administration	1,094,458	65,146	(614)	1,158,990
Distribution and transmission	723,423	-	(9,372)	714,051
Engineering services	314,561	-	(1)	314,560
Renewable energy	106,151	-	-	106,151
Water and wastewater operations	-	1,875,581	(762,554)	1,113,027
Total operating expenses	25,819,497	2,382,702	(772,956)	27,429,243
Operating income (loss)	1,123,071	(1,998,555)	-	(875,484)
Nonoperating revenues (expenses):				
Grants from the United States Government	345,258	-	-	345,258
Interest income	538	-	-	538
Gain on disposal of assets	250	-	-	250
Operating subsidies from the Republic of Palau	-	2,672,734	-	2,672,734
Writedown of generators	(200,000)	-	-	(200,000)
Interest expense	(404,185)	-	-	(404,185)
Writedown of generation parts and supplies inventory	(870,000)	-	-	(870,000)
Other	1,440	-	-	1,440
Total nonoperating revenues (expenses), net	(1,126,699)	2,672,734	-	1,546,035
Loss before capital contribution and special item	(3,628)	674,179	-	670,551
Capital contribution:				
Grants from the Japan Government	3,432,642	-	-	3,432,642
Special item:				
Transfer of water and wastewater operations	-	13,619,437	-	13,619,437
Change in net position	3,429,014	14,293,616	-	17,722,630
Net position at beginning of year	27,949,394	-	-	27,949,394
Net position at beginning of year	\$ 31,378,408	\$ 14,293,616	\$ -	\$ 45,672,024

See accompanying independent auditors' report.